THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 268 **August 1995**

Myths and Realities

"The rate of interest at which the demand for loan capital and the supply of savings exactly agree, and which more or less corresponds to the expected yield on newly created capital, will be the normal or natural real rate."

Lectures on Political Economy
Knut Wicksell, 1978 (reprint)

The bullish frenzy on Wall Street shows signs of wearing thin. Of the recent gyrations in the stock market, particularly in the overheated technology stocks, we have little to say, except to note that such volatility is typical in the dying days of any speculative bubble.

As always, the bond market remains the key to Wall Street's boom. Alarmingly for the bulls, bonds appear to be in the midst of a significant correction. Since June 22, the yield on the 30-year Treasury bond has risen 43 basis points, erasing more than 30% of its decline since the start of the year. The yield on the two-year bond, so favored by the leveraged carry-trade players, has jumped 39 basis points since hitting its low on July 6.

Given the role the U.S. bond market has played in leading this year's global bond rally, this reversal is of crucial importance to markets and economies worldwide. As in 1987, speculative excesses have left the U.S. stock market extremely vulnerable to a bond sell-off. The threat of a more generalized global crash also cannot be dismissed.

Ironically, foreign investors themselves may be the force that tips the scales. New statistics illustrate the degree to which foreign buyers – both private and official – sparked the U.S. bond rally earlier this year, at a time when domestic investors either were staying on the sidelines or were actively selling. We find this bullishness puzzling, given the dollar's plight. Apparently, massive dollar hedging has been used to offset currency risk. But this is costly. We can only wonder how long foreign investors will be willing to pay those costs if U.S. bonds turn bearish.

Clearly, U.S. financial markets are at a crossroads. Accordingly, in this letter we would like to offer an overview of the fundamentals underlying those markets. What we see is a paradox: a chronic boom in financial assets, coupled with a chronic decline in real capital formation. That U.S. stocks are setting record highs, even as net investment remains mired at the lowest levels since the Great Depression, is but one example of this amazing dichotomy.

We realize this bearish view completely contradicts the euphoric consensus, which holds that U.S. industry is undergoing a miraculous regeneration. Indeed, this is the central bullish story underlying the current boom. It implies that any economic weakness, even a recession, is but a temporary deviation from the longer-run, secular upwave.

We utterly disagree. A close examination of trends in productivity, profits and investment forces us to conclude the United States has not reversed the disastrous spiral of overconsumption and underinvestment that has undermined its economy over the past three decades. Recent statistical revisions lend additional support to our views.

In truth, only the Federal Reserve's loose-money policies, and the forbearance of America's official foreign creditors, have allowed the boom on Wall Street to reach such dizzying heights. This can't last forever. As with all bubbles, the psychological breaking point will arrive. Sooner or later, myths must give way to the hard realities.

THE FED EASES

Undeterred by the weak dollar, the persistent, huge trade gap and the frenzied tide of speculation in the financial markets, the Fed moved last month to cut its federal funds rate from 6% to 5.75%. And not only that. By explicitly stressing that "inflationary pressures have receded enough to accommodate a modest adjustment in monetary conditions," the Fed sent the implicit message that more easing lies ahead. As could be expected, financial markets around the globe took the cue with a vengeance.

Because the move took place just one day before the scheduled publication of U.S. employment data for June, it was widely conjectured the Fed had moved based on confidential knowledge of a weak job report. But as the actual numbers proved surprisingly strong, it seems in hindsight more logical to conclude the Fed acted as it did in anticipation of stronger, not weaker, data. The June report might have forestalled or inhibited a later easing move. Apparently, the Fed was impatient to ease.

While the markets celebrated, we pondered the true reason for this unseemly haste. We found it odd, considering the strong stimulus already in place due to the weaker dollar and the sharp reduction in market interest rates since the first of the year. What's more, U.S. credit conditions have remained extremely loose, despite the Fed's rate hikes of 1994 and early 1995. Lenders, above all banks, couldn't be more aggressive in expanding their loans. So why, we wonder, did the Fed cut rates, given the extremely precarious condition of the dollar?

Was it, perhaps, to safeguard the reckless bulls of Wall Street? Certainly, the bond speculators were heavily dependent on a Fed cut, having already driven market rates down to levels incompatible with a 6% federal funds rate. Far from wishing to put a lid on this increasingly feverish, speculative frenzy, the Fed clearly wished to keep it going, apparently out of fear that any setback in the financial markets might jeopardize the economic expansion. After the experience of last year, in which its first, token tightening moves triggered a massive sell-off in the bond market, the Fed appears unwilling to risk puncturing the bubble a second time. We would say the Fed has become the slave, rather than the master, of market expectations.

Of the larger perils inherent in encouraging and perpetuating speculative bubbles, the Fed seems completely oblivious. This was evident in Mr. Greenspan's recent testimony before Congress, in which he specifically praised the rampant bullish mood on Wall Street. "Lower interest rates have helped to buoy stock prices, which have soared ever higher," he boasted. "The positive implications of this rally in financial markets for household debt-service burdens and wealth and for the cost of capital to businesses augur well for spending on consumer durables."

Unfortunately, bubbles simply cannot last forever. Some day, they go bust. But the longer the euphoria lasts, the more people come to believe the absurd rationalizations used to justify the mania – namely, the old siren song that sings of a fabulous new era of permanently high and rising capital values.

We, on the other hand, constantly have attempted in these letters to penetrate Wall Street's smoke screen of lies and fairy tales, and bring to light the adverse trends we see at work in both the U.S. economy and U.S. financial markets. Such fundamental analysis – not the technical formulas of the chartists, or subjective interpretations of speculative sentiment – always has formed the basis for our views and our advice.

For that reason, we would like to step back a bit from recent developments in the markets in order to restate both the theoretical principles that guide our thinking, and the specific facts that have led us to take such a profoundly bearish view of the boom on Wall Street. Our goal, in a sense, is to reveal the anatomy of a bubble.

Actually, the late 1980s and the first half of the 1990s have seen asset bubbles of all kinds worldwide, meaning asset price inflation. Many countries have seen runaway inflation in the prices of real estate, both residential and

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (July 28)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	4.0%	10.8%	3.8%	-0.7%	16.2%
Canada	1.8%	9.4%	11.1%	-2.1%	15.5%
France	3.6%	2.8%	-5.9%	-8.7%	12.3%
Germany	6.0%	5.9%	5.1%	-0.5%	16.7%
Hong Kong	3.3%	15.4%	0.5%	-7.0%	35.6%
Japan	13.9%	-15.6%	-17.8%	-20.2%	14.9%
Mexico	10.6%	1.2%	-1.0%	-15.8%	66.1%
Spain	3.9%	8.8%	1.4%	-3.2%	17.2%
U.K.	5.7%	13.2%	12.1%	0.0%	17.9%
U.S.	3.3%	22.6%	23.9%	-0.4%	26.4%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (July 28)	Current Rate (%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	9.40	52	-60	-22	-132	77
Canada	8.35	55	-79	-101	-133	67
France	7.38	-15	-89	5	-105	20
Germany	6.79	-1	-83	-13	-97	30
Japan	2.99	20	-159	-150	-197	38
Spain	11.35	-40	-49	83	-124	119
U.K.	8.23	-21	-48	-33	-80	55
U.S.	6.47	39	-135	-81	-156	45

Exchange Rates

Versus U.S. Dollar, % Change

Country (July 28)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.36	2.7%	-5.3%	-0.4%	-5.7%	3.8%
Canada ($)	1.37	0.6%	2.5%	1.1%	-1.9%	4.0%
France (*f*)	4.78	2.3%	10.4%	12.0%	-0.4%	12.4%
Germany (DM)	1.38	1.1%	10.9%	13.2%	-2.1%	13.2%
Japan (¥)	88.2	-3.0%	11.5%	12.0%	-9.3%	13.2%
Spain (Pt)	118.3	3.4%	10.1%	9.9%	0.0%	11.8%
U.K. (£)	1.60	1.5%	2.3%	4.8%	-2.4%	4.9%

commercial. In the same vein, the U.S. stock market boom of the 1980s must rank as a bubble, because it was fueled by the debt-driven corporate takeover boom. Another huge bubble was inflated in the early 1990s by frenzied speculation in the high-yielding bonds of the European soft currencies. This was followed by the even larger, global bond bubble of 1992-93. But by far the worst example, with the worst consequences, was Japan's real-estate and stock bubble of 1986-89.

Each and every one of these bubbles eventually burst. Yet the Fed and the world's other leading central banks have been successful, if sometimes only barely, in reflating the financial markets after each disastrous episode. Japan is the great exception. Its asset markets remain in a deep slump, propped up solely by government intervention.

Remarkably, the current speculative frenzy is strictly confined to financial or paper assets – in other words, to Wall Street. Prices of commercial and residential real estate have yet to recover from the crash of the early 1990s. At best, they are stagnating.

This coexistence of booming financial asset values and abysmal capital formation is something worth thinking about. Our short explanation: Wall Street's exclusive role in the current bubble simply reflects the fact that in the 1990s, it is by far the most efficient venue for initiating and financing speculation.

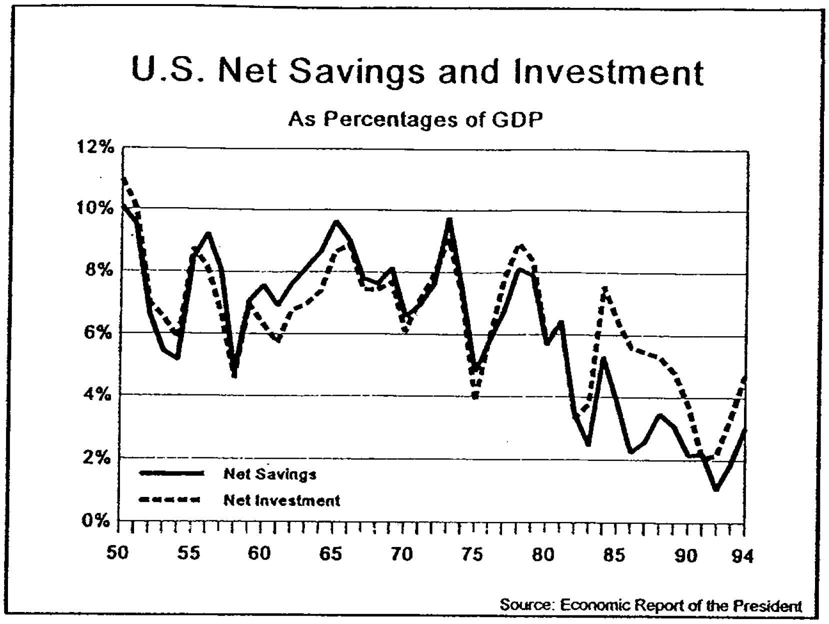
THE ANATOMY OF A BUBBLE

All this raises the question: How does one define and measure a "bubble"? It is possible at all? It definitely is. All that is required is a careful analysis of the flow of funds feeding a rising market.

The old economists of the classical school knew the answer. They understood that the flow of funds into any market can be broken down into two sources: savings, either of individuals or the retained profits of corporations; or inflationary credit or money creation. The large-scale presence of the latter constitutes the telltale evidence of a bubble.

As it happens, the long bull market on Wall Street – a bull market that has continued almost without interruption since 1982 – has coincided with a collapse of the U.S. net national savings rate from more than 7% to a low of just 2% of GDP in recent years. Net national savings is the sum of individual savings and business savings, minus federal, state and local budget deficits. Essentially, it constitutes the only non-inflationary source of domestic funds

available to finance net lending and investment. Given this collapse in net savings, Wall Street's boom, strictly speaking, has been an inflationary bubble right from the very beginning. In 1993, the U.S. net national savings rate was a threadbare 1.8% of GDP. It staged only a modest recovery last year, rising to 3.04%. This dismal savings picture has two parts – sharply lower private savings and sharply higher federal budget deficits.



U.S. investment, though, has not declined quite as steeply as savings. Large foreign capital inflows have enabled investment levels to remain higher than the level of domestic savings would suggest. Yet, the decline in investment also has been dramatic. During the 1950s, 60s and 70s, the net domestic investment rate – business and residential – averaged 7-9% of GDP. So far in the 1990s, it has averaged less than 3%, a new secular low.

It used to be accepted wisdom among economists that the key test of any economy's health and viability is the trend shown in saving and investment, because they are the key determinants of increased productivity, and consequently of high-paying jobs and rising living standards. By these two measures, the U.S. economy definitely is on a downward path.

Cogent evidence of this long-term economic trend can be found in one particular fact, namely, the fact that real average weekly earnings have been in permanent decline since 1973, a decline that so far has totalled 19%. In the last 12 months alone, real earnings have fallen 2% overall, and 2.3% in manufacturing.

To stay afloat, the average American family has resorted to three devices: it has increased work participation by wives and mothers; it has increased moonlighting (holding extra jobs); and it has gone heavily into debt. Debt has replaced income. In recent years, piling up mortgage debt on homes has become the most convenient way for U.S. consumers to borrow from the future. Since 1992, equity in owner-occupied homes has fallen from 73% to 57%.

ILL-STRUCTURED GROWTH

It is true that since the early 1980s the United States also has had stronger economic growth than any other industrial country. But it has been seriously ill-structured growth. Between 1980 and 1995, unproductive government and consumer debts rose a staggering 290%, compared with GDP growth of 149%. All the growth was borrowed from the future. It inflated consumption from 63.4% of GDP in 1980 to nearly 69% in 1994. The chief counterpart to this chronic overconsumption has been chronic underinvestment and the huge trade deficit, financed by heavy borrowing from abroad.

As a result, the U.S. international investment position has switched from a net surplus of $257 billion in 1983 to a net debit position of $658 billion in 1993. By now, this accumulated foreign debt probably exceeds $800 billion. Yet this total still falls considerably short of the cumulative U.S. current-account deficit of $1.3 trillion. Why? Because the steady, steep decline in the dollar over the past 12 years has given a huge boost to the dollar value of U.S. assets in the hard currencies – the flip side of the huge depreciation in the value of the dollar assets held by

America's foreign creditors. In essence, the United States has repudiated a large share of its foreign debt through the expedient of dollar devaluation. Yet, despite these currency gains, the U.S. net balance on investment income is currently about $25 billion in deficit, compared with a $35 billion surplus in the early 1980s.

Is this an economic success story, as painted and celebrated by Wall Street? We would say it is the story of an outright disaster in capital formation, a disaster with far-reaching adverse implications for the entire U.S. economy, and particularly for future productivity growth and the balance of payments.

Frankly speaking, that such an unprecedented disaster in real capital formation could coincide with an unprecedented boom in the market value of financial assets strikes us as an exercise in economic absurdity. Looking for an explanation, we see only one: a prolonged speculative mania fueled by the Fed's persistent loose-money policies.

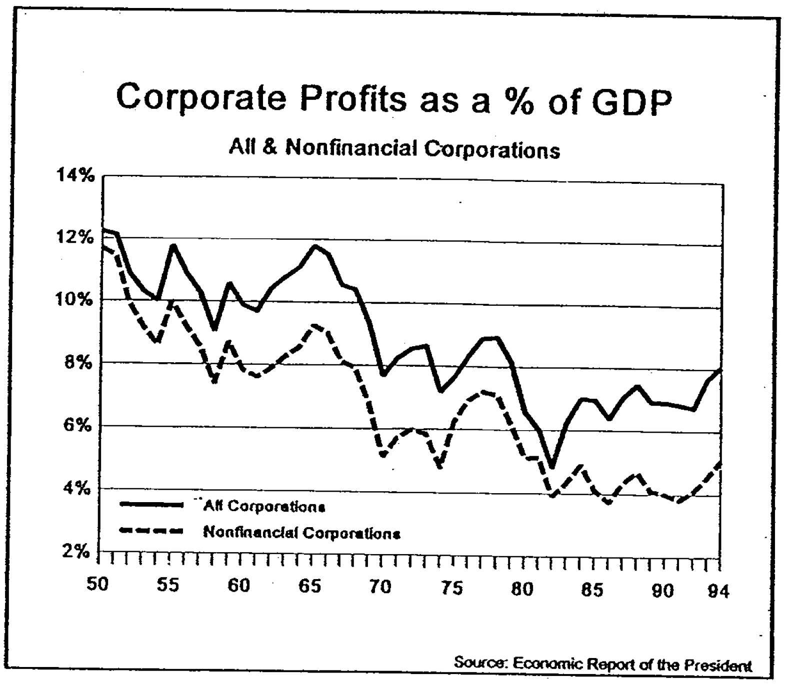
Wall Street's euphoric answer, on the other hand, is to glorify downsizing, which allows additional profits to be squeezed from the same or even lower levels of production by slashing costs, above all labor costs. By the same token, the weak dollar is welcomed in the stock market primarily because it creates instant currency gains on the existing overseas earnings of U.S. corporations.

THE GREAT PROFIT DELUSION

We never have shared the enthusiasm of U.S. economists and the stock market for closing plants and slashing jobs. The U.S. manufacturing base obviously now is much "leaner" and more efficient. But this has been achieved largely at the expense of new investment in future growth. Certainly, U.S. manufacturing has not been able to keep pace with the boom in domestic demand fed by the explosion of consumer credit. As a result, the ongoing U.S. expansion has sucked in huge flows of imports, while the manufacturing trade balance has moved into permanent structural deficit. Plainly, Corporate America not only has trimmed the fat, but its muscles as well.

Nor have we ever believed that an economy can downsize its way to permanently higher profits. This is nonsense. Though U.S. business profits have risen in recent years, this is not due to any sort of productivity "miracle," as advertised on Wall Street. As yet, the statistical record shows no secular improvement in U.S. productivity, aside from the normal positive effects of the business cycle. And we believe even these modest gains should be viewed with considerable skepticism.

In the first place, there is rather less of a profits recovery than Wall Street would like us to believe. To get a true picture, it is necessary to measure profit growth against growth in the overall economy. The accompanying chart shows that while profits as a percentage of GDP have risen somewhat in recent years, they remain well below their average levels from the 1950s, 60s and 70s. The 1960s, it may be remembered, also were low-inflation years. In any case, much of the profits recovery has been in the booming financial sector, as seen in the sharp divergence of nonfinancial profits and total profits.

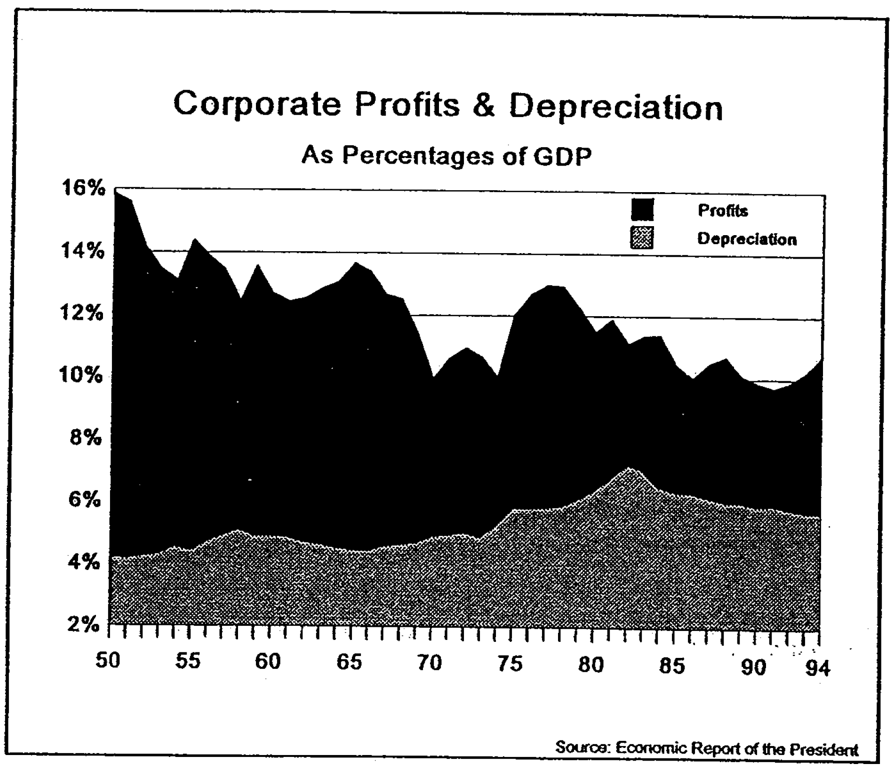


Nevertheless, it is true that U.S. profits have recovered somewhat since their lows in the deep

recession of 1981-82, even though when measured as a fraction of GDP, their longer-term trend appears much less impressive. But if it was not a productivity revolution that fueled this revival, what did? Altogether, we have identified five different factors:

- A relative decline in capital depreciation, due to protracted underinvestment. In a very real sense, U.S. industry has been milking its own capital base to support current earnings.
- A sharp decline in interest rates. In the past three years in particular, we would credit nearly all of the U.S. profit improvement to this factor.
- Currency gains on profits earned in the hard-currency countries. For example, these accounted for fully half of the record earnings reported by IBM in 1995's second quarter.
- A harsh drive to hold labor costs below inflation, and below even the subpar productivity gains recorded in recent years.
- The virtual disappearance of contributions from corporations to their defined-benefit pension plans.

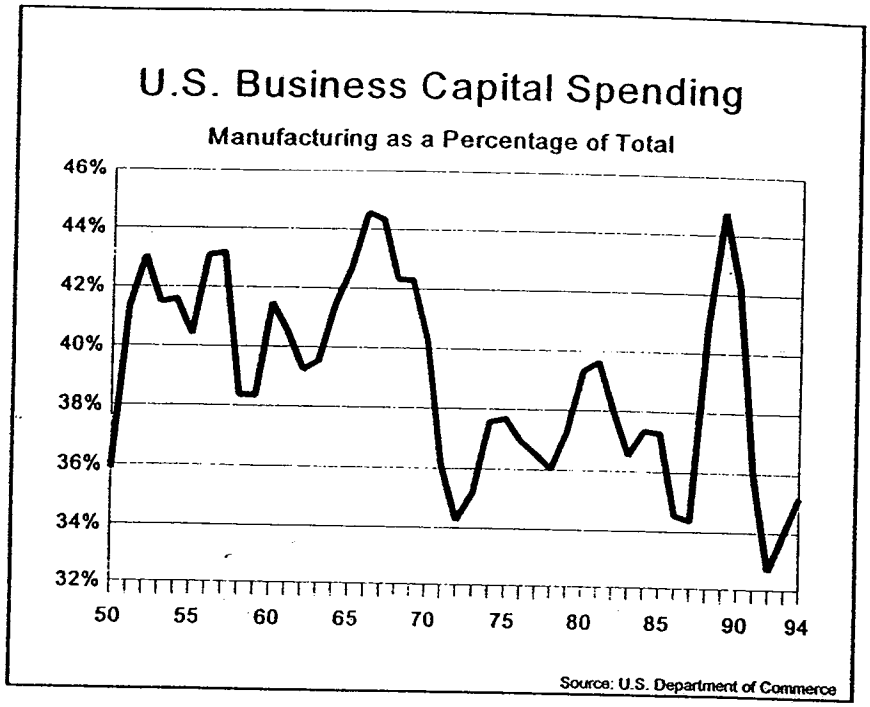
Of these five profit sources, two appear predominant. One is the growing shortfall of depreciation relative to GDP and income growth, reflecting the persistent weakness in new investment; the other is the steep decline in interest rates during the 1990s.



Indeed, we think the trend in capital consumption allowances should be considered in conjunction with profits as the best available measure of corporate strength. Taken together, the two are a key gauge of overall earnings power and potential growth. This is far superior to the simple price-to-earnings ratio, which tells nothing about underlying capital formation.

Seen in this light, the trend in U.S. corporate performance is even more disturbing. Over the past four decades, profits and depreciation, as a share of GDP, have declined in line with profits alone, as the above chart shows. Indeed, during the 1980s, a further deep slump in the profits of nonfinancial corporations was avoided only through a sharp reduction in capital depreciation costs.

Of the remaining three profit sources, two – currency gains and the labor shake-out in manufacturing – are familiar trends, though frequently neglected. But the fifth source – diminished pension contributions – is widely unknown. In the 1970s, with the financial markets generally depressed, corporations had to make large cash payments to their pension plans, at the expense of profits, in order to fund current and future liabilities. But, since the early 1980s, profits have been bolstered by the fact that pension liabilities have been overwhelmingly funded by capital gains accruing from the boom in stocks and bonds.



In any case, all of these profit sources basically are negative. The decline in depreciation reflects chronic underinvestment; the decline in interest payments reflects loose money; the currency gains reflect the falling dollar; and the low pension contributions reflect asset-price inflation at the expense of savings.

Considering the assistance provided by all these dubious influences, the actual performance of U.S. corporate profits appears extremely poor.

THE INVESTMENT SHIFT

It is true that U.S. fixed investment has rebounded since 1992. But it remains far below the investment ratios of Japan, Germany and most other countries. This observation applies especially to net investment – that is, gross investment less charges for depreciation. Net investment or net capital formation was lower only during the Great Depression of the 1930s, when it sank to 2.1% of GDP.

Net investment increasingly is falling short of gross investment because there also has been a major shift in new investment away from long-lived structures towards shorter-lived machinery and equipment. Because these are subject to faster depreciations, this shift adds to the decline in the share of net investment. The fact that depreciation itself has nonetheless declined as a share of GDP is evidence of the rapidity with which the U.S. capital base is eroding. Worse, the United States is the one and only major industrial country experiencing strong population and employment growth. So per-capita investment is virtually nil.

As the same time, there has been a massive shift away from goods-producing investment to service investment, in particular computers for office automation. Computers have accounted for fully 60% of the investment growth in business plant and equipment since the early 1980s. This is one place where there certainly has been no underinvestment. But investment in information is no substitute for lack of investment in facilities for producing tradable goods.

Still another distorting factor in the investment statistics is the big shift in the United States from buying to leasing automobiles. A car bought appears in the statistics as consumer spending. A car leased appears as an investment by the leasing company.

In short, there has been no breakthrough in U.S. investment growth, and consequently no breakthrough in productivity growth. We think the existing, widespread illusions regarding this issue will be swept away when the Commerce Department shifts to a new type of GDP measurement later this year. This new methodology is designed to correct distortions caused by the use of outdated price indexes, which in particular greatly exaggerate current investment in computer equipment.

The practical result of this shift will be a drastic downward revision in GDP. For example, growth in 1994's fourth quarter will be cut to 4% from 5.1%, while first quarter 1995 growth will fall to 1.7% from 2.7%.

Putting it succinctly, our key point is what we earlier dubbed the great U.S. economic paradox: The capital boom on Wall Street has had no counterpart in a capital boom in the real economy. Quite to the contrary, the real economy has been and remains locked in a state of capital shrinkage, as overconsumption continues to depress investment. For Friedrich Hayek and the Austrian school of economists, it was just this kind of process – a so-called "shrinkage of the production structure" – that precipitated the Great Depression of 1929-1933.

Together with the rapid rise in America's foreign indebtedness, this chronic investment atrophy is a frightening development. In combination, the two essentially boil down to raising present consumption at the expense of future consumption. But the endless boom on Wall Street seems to eclipse this economic demise. We have no difficulty identifying the root cause of this dichotomy: a permanent state of loose money.

THE FED BREEDS ASSET INFLATION

In the consensus view, the Federal Reserve has done an excellent job of fighting inflation. But the truth is that inflation has remained rampant in the United States, despite the decline in the conventional price indexes. Rather, monetary inflation has manifested itself in the prices of another class of goods – financial assets – and in the huge, chronic U.S. trade deficit.

Saying this, we are aware there are two fundamentally different concepts of inflation. In the United States, inflation generally has been defined narrowly as a sustained rise in the price indexes. Traditional European definitions, by contrast, define inflation in terms of its underlying cause – the excessive creation of purchasing power.

In this view, rising prices of goods and services merely are one specific symptom of inflation. But, depending on circumstances, excess money may well find its outlet in the asset markets, or in a soaring increase in imports and a widening trade deficit. Both represent undesirable and unsustainable imbalances.

This dispute about the essence of inflation has an interesting historical antecedent, one that says realms about the sad state of current economic thinking. In 1928, the British economist John Maynard Keynes was told by one of his colleagues on the board of directors of a British insurance firm that there was a serious inflation problem in U.S. stock prices, and that the Fed soon would deal with it through monetary tightening. If the Fed did not act, this director argued, there would in any case be a severe correction in the market. Therefore, he advised, the firm should dispose of the bulk of its American securities.

Keynes was aghast. It was not convenient, he replied, to define inflation as anything else other than rising consumer prices. The test of inflation, he insisted, was the "test of prices." Judged by the indexes of consumer and commodity prices, America at the time had zero inflation, or even deflation, Keynes noted. Nevertheless, he wrote to various British and American economists – including Benjamin Strong, the powerful president of the New York Fed – asking their advice on this question.

Keynes found his American correspondents united in their disagreement with his position. Through another Fed official, Strong passed along the word that he had found "so many points where Keynes was wrong either in his facts or in his conclusions that it would be too much to reply." Three other economists explained to Keynes in great detail that he was wrong to confine the definition of inflation to consumer and commodity prices. All three insisted that America had rampant inflation in three other directions – credit growth, stock prices and real-estate prices.

Keynes never agreed. And if the value of an economist's theory can be judged by the performance of his portfolio, Keynes fares very badly indeed. By the end of 1929, he was almost wiped out, for the second time in his investing career. He lost about 85% of his money – not on Wall Street, to be sure, but by speculating long in commodities. The losses on those positions forced him to sell his British securities, by the end of 1929 into a declining market.

Ironically, Keynes' cautious fellow director, Oswald Falk, also was completely wiped out, because after reversing his previous pessimistic position, he decided to "bull" Wall Street just before the crash. He had to sell his house to cover his losses.

This story reveals one crucial difference between the Federal Reserve of the 1920s and the Federal Reserve of the 1990s. The Fed of the 1920s worried immensely about "inflation" on Wall Street, while today's Fed is its biggest fan and cheerleader. Indeed, by word and deed the Fed now does everything it can to support and encourage inflationary speculation.

THE DEATH OF THEORETICAL ANALYSIS

It long has been our view that the level of theoretical thinking these days is far below what it was in the 1920s and 1930s. In fact, such thinking no longer exists, least of all in the markets. Part of the reason is the general belief that computers and mathematics are better tools for analysis than conceptual thought. Even more important may be the general, drastic shift in the time horizon of market participants from the long to the short run. Even the short-run is shorter than ever. In the past, it used to mean the next several months. Now, it may mean the next few minutes.

We never travel with the herd if it goes against our conviction – which it often does. Yet it is perfectly clear to us that market moves are determined by three different sets of influences that often conflict: expectations, monetary conditions and fundamentals. We concentrate our analysis primarily on the latter, and on monetary conditions. Ever-changing expectations, by contrast, rank very low in our esteem. To often, they are based on sheer rubbish. Still, we realize the greatest rubbish may have strong effects on the markets if only sufficient people believe it.

Nevertheless, we always have regarded our main task as being to distinguish between short-term silliness and long-term fundamentals. Above all, we think it most important to investigate whether a given bull run is a mere speculative bubble or whether it is solidly based on sound and lasting fundamentals.

Some of our readers may well decide to play a bubble, in the conviction that they are smart enough to exit just before the crash. But we think they should know that they indeed are playing a bubble. Yet most speculators operate without such crucial knowledge, because they blindly believe the fantasies that the financial community produces and publishes.

How does one identify a speculative bubble? As we explained earlier, one does so by breaking down the flows of funds feeding a rise in asset prices. To repeat, we divide these into two categories: savings and inflationary sources.

In this vein, the old economists searched for the equilibrium interest rate that would equate the flow of loanable and investible funds with the supply of genuine savings. In this concept, any credit or investment flows not matched by current savings qualify as "inflation." These supplementary inflationary sources, in turn, can be divided into three different kinds: Bank lending, non-bank lending, and so-called cash-balance effects (that is, a decline in the demand for money, causing an reduction in the money holdings of consumers and investors).

In the United States, as can be easily verified in the official statistics, the flows of funds into the financial markets are grossly out of balance with the meager supply of domestic savings. During the first quarter of 1995, money flows into the U.S. credit and stock markets totalled $1.3 trillion, compared to a total supply of domestic savings of less than $300 billion, both at annual rates.

How are we to explain this torrential flow of money into the financial markets, considering that it has been grossly out of synch both with current savings and also with broad money growth? Though the latter has accelerated sharply recently, it has been extremely sluggish during the 1990s to date, averaging just 1.8% annual growth since 1990.

By this measurement, monetary policy has been extremely tight. Yet measured by the actual flows of funds, it has been extremely loose. What is the right measure?

Under the influence of the monetarists, it has become customary to gauge the monetary stance in a country by changes in current money growth. But it is rarely mentioned and widely unknown that there are two tacit presumptions behind this concept: a stable demand for money, and little or no change in financial structures.

THE MONETARY MUDDLE

The truth is that in the United States various things have happened to distort the monetary picture – to the point where money growth has become obsolete as a monetary gauge. The net effect is rampant credit creation plus soaring money velocity versus minimal money growth. This has three main reasons:

- Banks have been funding their runaway credit expansion largely with non-depository liabilities that are not counted in the money supply.
- Credit creation increasingly is taking place outside of the banking system, through capital markets and non-bank financial intermediaries. This involves no deposit or money creation.
- There has been an unusual, massive shift in the public's asset preference away from money towards bonds and stocks. Or to put it differently, there has been an extraordinary decrease in the demand for liquid money balances. But the flood of money thus set in motion has poured overwhelmingly into the financial markets, rather than into the real economy. This has boosted bond and stock prices, rather than commodity and consumer prices.

This sweeping shift in asset preference is the most exceptional part of the whole story. All the asset bubbles of the 1980s – in the United States, Britain, Japan and elsewhere – were associated with rapid credit and money growth. However, the bubbles of the 1990s have occurred against a backdrop of weak money growth in most countries.

Of the three causal factors we have cited, the latter two – that is, the shift in financing from banks to nonbank financial intermediaries and the capital markets, and the flight out of money balances into securities – are crucial. In both cases, speculative activity is financed not by growth in the money supply but by more intensive utilization of the existing money stock, or in monetary jargon, by increasing money velocity.

But why has this happened so suddenly, and on such a massive scale? The short answer is: This surge in speculative activity was triggered and fueled by the ultra-low short-term interest rates imposed by the Fed during the early 1990s, as it sought to save the U.S. banking system and refloat the American economy.

FOREIGNERS TO THE RESCUE

However, this is only a monetary explanation of recent events. To set frenzied speculation in motion requires an additional trigger or catalyst. Yet the strange thing about the U.S. financial boom that started last November is that it took Wall Street almost completely by surprise. Actually, the consensus at the time was expecting and betting heavily on a stronger U.S. economy, accompanied by rising inflation and interest rates, and a rising dollar.

Who, then, provided the initial thrust to Wall Street's boom, if not Wall Street itself? Though hard to believe, the statistics reveal that the main catalytic agents were foreign central banks and private foreign investors. Together, they poured $86 billion into the U.S. Treasury market during the last quarter of 1994 and the first quarter of 1995. During this same period, net purchases by U.S. investors were a mere $21 billion.

In general, domestic investors remained on the sidelines or even sold bonds, waiting for the market to reverse its torrid rise. Only when the economic data in April and May revealed – against almost all predictions – a weakening U.S. economy, did American investors hurriedly jump on the bandwagon, after bond yields already had dropped sharply.

Foreign net buying of Treasuries has continued apace right up to the present, amounting to $39.6 billion in 1995's second quarter, after $33.3 billion in the first. Both central banks and private foreign investors have continued to participate.

In theory, these huge private and official portfolio capital inflows have been sufficient to finance or even over-finance the enormous U.S. current-account deficit. So why have they not helped the dollar? Essentially, there were huge capital outflows that acted as an offset to those purchases. The most plausible explanation to us is that private foreign investors engaged in short-term currency hedging of their dollar positions on a massive scale. This necessarily generated large short-term capital outflows.

Like Wall Street, we also must plead guilty to failing to foresee the latest bull run in the bond market. But the chief reason for our failure, ironically, lies in our timely prediction early this year of a looming dollar crisis. As a weakening currency ordinarily bodes ill for the bonds that are denominated in that currency, we remained bearish on U.S. bonds.

Yet quite exceptionally, the U.S. bond market boomed without even taking notice of the falling dollar, while the stock market benefited from both falling bond yields and the falling dollar, which created windfall gains in foreign earnings for many U.S. corporations.

HISTORY DOES REPEAT

The buying frenzy on Wall Street has surprised us, but it has never convinced us. Comparing the torrent of financial flows with the meager trickle of domestic savings, it is clear to us that the current boom is yet another speculative bubble destined to burst one day. Yield is held in contempt, quick capital gains are the predominant and often exclusive objective. These are the distinguishing hallmarks of a bubble.

Basically, we see in the continuing boom on Wall Street the inertia customary in any inflationary process. It is a familiar phenomenon that after a prolonged period of inflation, past inflation rates come to set the norm for current inflationary expectations. For many investors, the long boom in stocks has set a norm that is expected to last far into the future.

This trend really is no different from the fantastic expectations built into the prices of many primary commodities and precious metals by the end of the long inflation of the 1970s. We find it remarkable that so many investors and analysts have such difficulty grasping the analogy.

We will leave it up to the kept economists of Wall Street to invent the plausible sounding stories that explain why stock prices must continue to rise as far as the eye can see. Still, we think it important to be aware of the fact that this another bubble waiting for some needle to prick it. We can only offer our readers the time-tested wisdom of Joseph Schumpeter, who watched a very similar process unfold in the 1920s:

"There is of course much more scope for waves of optimism and pessimism on the stock exchange than there is in industrial and commercial businesses," he wrote. "It remains true that irrational fancy and downright foolish hopes or fears count for much in the short run. But it is no less true that they never prevent the real state of things from asserting itself eventually."

CONCLUSIONS

Last month's rate cut marks another step in the Fed's tightrope walk between a dollar collapse (if it cuts rates too sharply) and a bond-market debacle (if rates are not cut enough). The recent sharp sell off in both bonds and stocks suggests Wall Street's patience is wearing thin. With the slowing economy beginning to take its toll on earnings expectations, the stock market increasingly looks to the Fed to keep the rally going. The bond market, having discounted a series of Fed easing moves, now worries those expectations will not be validated.

We think the Fed is doomed to disappoint both camps. Current interest-rate differentials already are insufficient to support the dollar without sustained, heavy intervention. Any further cuts only will worsen matters. Yet only deep and rapid rate reductions can push the bond bubble higher. Deprived of such momentum, bond prices must deflate, triggering a more serious correction in the U.S. stock market.

But the Fed faces an even greater long-run dilemma. Given the grim underlying trends in productivity, profits and investment, only a steady regime of low interest rates can sustain U.S. economic growth. Yet holding rates below equilibrium levels greatly aggravates the dollar's chronic structural weakness. This occurs through two channels:

- By overstimulating consumption and nonproductive investment, the Fed's loose-money policies push growth beyond the economy's existing capacity. This leads to a surge in imports, and an exploding trade deficit.

- By fueling the bubble on Wall Street, the Fed helps generate a tidal wave of investible funds, including capital gains from the booming stock and bond markets. At the same time, low U.S. rates and dividend yields create an incentive for speculators and investors to seek higher yields abroad. The resulting capital outflows lead to a steady deterioration in the long-term capital account.

By depressing the dollar, easy money and low interest rates may create the right environment for a rebound in U.S. manufacturing investment But low rates and the falling dollar also prevent the net capital inflows needed to finance investment-led growth. In economics, as in life, there is no free lunch.

We should stress, as we have many times in recent letters, that this game would have ended in a crash long ago without sustained support of the dollar by foreign central banks, particularly the Bank of Japan. For that reason, we think investors should look to the BoJ, not the Fed, for hints about the future course of U.S. monetary policy.

Facts and logic both tell us that the current boom on Wall Street is unsustainable. We can only repeat our long-standing advice: Seek liquidity and safety in the cash and short-term bonds of the hard-currency countries, primarily Germany, Switzerland, Austria and the Netherlands.

THE RICHEBÄCHER LETTER

DR. KURT RICHEBÄCHER, Publisher and Editor

Bill Montague, Associate Editor

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 1129 E. Cliff Rd., Burnsville, Minnesota, USA 55337. Subscription orders may be placed toll free from inside the USA by calling **(800) 894-3424**. For all other inquiries, and to order from outside the USA, please call **(612) 894-4088**. Fax: **(612) 895-5526**. Subscription rates: North America, U.S. $400. Outside North America: U.S. $420, or DM 630. Published monthly.